

China Venture Capitalist Confidence Index™

(Bloomberg ticker symbol: CVCCI)

Second Quarter – 2008

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Mark V. Cannice, Ph.D.

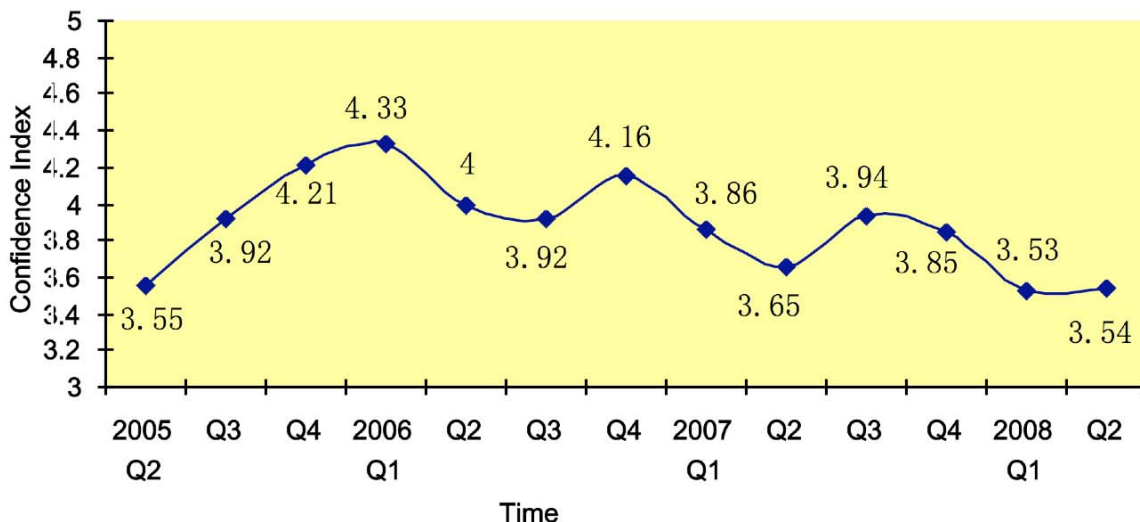
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The quarterly *China Venture Capitalist Confidence Index* (Bloomberg ticker symbol: CVCCI) is based on an on-going survey of Mainland China and Hong Kong venture capitalists. The China VC Index measures and reports the opinions of China-based professional venture capitalists in their estimation of the high-growth venture entrepreneurial environment in China over the next 6 - 18 months.

In publishing a recurring confidence index of China-based venture capital investors, we intend to utilize the local knowledge and insight of our respondents to provide an essential perspective and an on-going leading indicator of the dynamic Chinese entrepreneurial business environment. Further, by tracking what local venture investors project about the high-growth venture environment rather than what has already occurred in terms of investment flows, we hope to provide actionable insight for all market participants.

Graph 1

Trend Line of China Venture Capitalists' Confidence over the Recent 13 Quarters



The China Venture Capitalist Confidence Index for the second quarter of 2008, based on a July 2008 survey of 12 Mainland China and Hong Kong venture capitalists, registered **3.54 on a 5 point scale** (with 5 indicating high confidence and 1 indicating low confidence). This quarter's reading is

essentially unchanged from last quarter's measure of 3.53 and mirrors the historical low reading of this Index dating back to Q2 2005. However, the consecutive similarly low readings for Q1 and Q2 2008 demonstrate a consolidation point from a technical analysis perspective and suggest a bottom of China-based venture capitalist confidence in the future high-growth entrepreneurial environment in China. Please see Graph 1 for trend data.

This report's commentary and index reading are based on a sample of twelve venture capitalists in China. The Index respondents' names and firms for this report are listed in Table 1, save those who wished to remain anonymous. Some of the responding venture capitalists also provided commentary that supported their degree of confidence in the near term venture investment environment. In the following, we provide many of their comments along with our analysis.

China venture capitalists' low sentiment appeared to stem from their growing concerns over challenging macro economic conditions. For instance, a venture capitalist who wished to remain anonymous attributed his low confidence to "the high inflation environment and tight credit policies." In addition, another venture capitalist predicted that "there is likely to be a post-Olympics letdown, that when combined with the current global economic problems, will further limit public market exit opportunities."

With capital from international and domestic sources continuing to pour into VC funds, excessive valuations are becoming a concern. A VC respondent who commented off the record indicated that, "valuations are still way out of line and P/Es are too high." This may be due to the rapidly growing influx of capital. According to the Zero2IPO China Venture Capital Report Q2 2008, 40 new venture capital funds raised a total of \$3.02 billion.¹ This is a new record of capital inflows for one quarter to the venture industry in China. Among the new funds, 31 are domestic funds with \$1.2 billion, and seven are foreign funds with \$1.7 billion.²

The surge of funds into the China venture industry may have been driven by perceived increasing investment risks China's public stock markets which have lost roughly half their value over the preceding quarters, as some investors may be pursuing the longer time horizon of venture investing. With money from both international market and domestic markets pouring into the Chinese venture funds faster than the increase of high potential deals, an imbalance could occur and lead to unsustainable valuations. An anonymous VC stated that "While China entrepreneurial environment has come a long way, the "anything goes" style is unhealthy and unsustainable. In the short term you will see a lot of high valuations and so called success stories; this will build up into a false bubble with dire consequences". But not all agreed on this point. Johannes Schoeter, of Victoria Capital Limited observed that there are "many more attractive companies seeking funding than long-term capital available for them."

¹ <http://www.zero2ipo.com.cn/2008/7/9/2008797037.html>, 二季度VC市场热度逼人, 募资超30亿美元, 投资同比增七成 投资规模思路分化, 境内退出已成主流, 本土创投全面发力

² <http://www.zero2ipo.com.cn/2008/7/9/2008797037.html>, 二季度VC市场热度逼人, 募资超30亿美元, 投资同比增七成 投资规模思路分化, 境内退出已成主流, 本土创投全面发力

The volatile stock market delayed the launch of China's "Growth Enterprise Market". Shenzhen Stock Exchange started preparing for Growth Enterprise Market³ back in October 2000. But this plan has been postponed several times. After its most recent meeting on July 10, 2008, Shenzhen Stock Exchange didn't announce the schedule of Growth Enterprise Market. Given the uncertain economy outlook and declining stock market, most venture capitalists predict that Chinese government might postpone launching Growth Enterprise Market to 2009.⁴ However, the delay may not significantly impact venture capital activities as start-ups can still go public through the Small-to-medium Enterprise Market. (In 2004, Shenzhen Stock Exchange started the Small-to-medium Enterprise Market as a temporary policy because Shenzhen Stock Exchange had been holding small-to-medium companies' stock offering requests ever since it began preparing the Growth Enterprise Market in 2000.⁵)

Still some VCs saw positive trends. Tony Luh of DFJ Dragon Fund China said "We continue to see strong growth and government backing of entrepreneurship." And Jessica Mak indicated that while "Inflation and the global economic downturn remain, tight credit provides an advantage for VC & PE to pick deals in China." Plus, the exit market for Chinese ventures was healthy in Q2 with 10+ venture-backed firms completing an IPO⁶ (compared to 0 US venture-backed firms in Q2).

In conclusion, although China's venture capitalists' confidence has been negatively impacted by slowing global economic growth, increasing inflation, tight credit, volatile stock market, and possible valuation bubbles; strong economic growth in the long term and a maturing venture capital investment system provide cause for enduring confidence. An anonymous venture capitalist expressed his on-going confidence by noting that "the next 18 months will be a good time to enter PRC deals, as valuations should get more rational". Despite of the delay of launching Growth Enterprise Market, domestic venture-backed IPO activities are still active thanks to the temporary Small-to-medium Enterprise Market that serves as an investment exit for venture capital backed firms. Active venture investment further proves venture capitalists confidence.

According to Zero2IPO China Venture Capital Report Q2 2008, 143 out of 159 start-ups that got venture capital investment in second quarter 2008 revealed a total investment amount of \$1.2 billion, a 28% increase compared the investment amount last quarter.⁷ Thus, a generally sound level of investments and exit opportunities for venture-backed firms coupled with a technical chart bottom for VC confidence suggest positive outlook in high-growth entrepreneurial activity in the near to medium term.

³ <http://baike.baidu.com/view/96367.htm>, 创业板的概念及特点. The Chinese government has been preparing to launch the 'Growth Enterprise Market' (GEM) for nearly 10 years. The GEM is focused on providing a vital capital market for technology growth enterprises, along with other functions. As such, the GEM is intended to help nurture the continued development of a vibrant technology industry in China by providing an alternative source of financing for technology enterprises as well as an exit opportunity for venture-backed firms.

⁴ <http://finance.sina.com.cn/stock/t/20080712/15205085569.shtml>, 风投人士料创业板至少延后至2009年, by Sina.com

⁵ <http://hi.baidu.com/fjyhhn/blog/item/315919db8b1f8a65d1164e1c.html>

⁶ Several sources indicated a different number of venture-backed IPOs from 10 – 18 in Q2.

⁷ <http://www.zero2ipo.com.cn/2008/7/9/2008797037.html>, 二季度VC市场热度逼人, 募资超30亿美元, 投资同比增七成 投资规模思路分化, 境内退出已成主流, 本土创投全面发力

Table 1
Participating China based Venture Capitalists in the
2008 2nd Quarter Confidence Index Survey

Alicia Eastman	Asia Pacific Capital
Chauncey Shey	Soft Bank China Venture Capital
Henry Man	WI Harper Group
Jessica Mak	
Johannes Schoeter	Victoria Capital Limited
Michael Scown	Intel Capital, Asia Pacific
Raymond Gu	JAFCO Asia
Steven Lin	CLSA Capital Partners
Tony Luh	DFJ Dragon Fund China
Anonymous	
Anonymous	
Anonymous	

Mark V. Cannice, Ph.D. is an Associate Professor of Entrepreneurship and the Founding Executive Director of the University of San Francisco Entrepreneurship Program (Cannice@usfca.edu). He has also been a Visiting Associate Professor with Peking University's Beijing International MBA Program (2005) and the Hong Kong University of Science and Technology School of Business (2005 - 2007). Ling Ding is a partner with MCLD Venture Resources and holds an MBA from the University of San Francisco (2006). The authors wish to thank the participating venture capitalists who generously provided their expert analysis and commentary as well as Tomosue Den (USF MBA candidate 2009) for his survey and technology support. Please see the reports for the previous quarters at: www.EntrepreneurshipProgram.org under the publications tab. Venture capitalists who wish to participate in next quarter's Index survey are asked to contact Professor Mark Cannice at Cannice@usfca.edu. Webmasters are welcome to link to this report with courtesy notification to Cannice@usfca.edu. To post this report on your website, please request permission by email to Cannice@usfca.edu. When citing the index, please refer to it as: The China Venture Capitalist Confidence Index (Bloomberg ticker symbol: CVCCI), and include the associated Quarter/Year, and the full names of the authors.

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